

REPORT OF EXAMINATION
OF THE
COAST NATIONAL INSURANCE COMPANY

AS OF
DECEMBER 31, 2005

Participating State
and Zone:

California

Filed June 8, 2007

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION.....	1
SUBSEQUENT EVENTS	2
COMPANY HISTORY	2
MANAGEMENT AND CONTROL:	3
Management Agreements	5
TERRITORY AND PLAN OF OPERATION	6
GROWTH OF COMPANY	7
REINSURANCE:	7
Assumed.....	7
Ceded	8
FINANCIAL STATEMENTS:	12
Statement of Financial Condition as of December 31, 2005	13
Underwriting and Investment Exhibit for the Year Ended December 31, 2005.....	14
Reconciliation of Surplus as Regards Policyholders from December 31, 2001 through December 31, 2005.....	15
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	16
Losses and Loss Adjustment Expenses	16
SUMMARY OF COMMENTS AND RECOMMENDATIONS:.....	16
Current Report of Examination.....	16
Previous Report of Examination.....	17
ACKNOWLEDGEMENT	18

Los Angeles, California
February 28, 2007

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Secretary and Commissioner:

Pursuant to your instructions, an examination was made of the

COAST NATIONAL INSURANCE COMPANY

(hereinafter also referred to as the Company) at the primary location of its books and records, 5701 Sterling Road, Davie, Florida 33314.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005 as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states; loss experience; and sales and advertising.

SUBSEQUENT EVENTS

Effective July 31, 2006, Bristol West Holdings, Inc., (BWH) the Company's ultimate parent, refinanced its senior credit facilities, and increased the debt portion of the facility to \$100 million, as supplemented by Pledge Supplement dated December 14, 2006. The new facility is due five years after the closing date. The facility is guaranteed by the non-insurance subsidiaries of BWH, and is secured by a lien on the stock of certain subsidiaries including that of the Company. No filing pursuant to Insurance Code section 1215.2 was submitted prior to this pledge agreement and lien on the Company's shares.

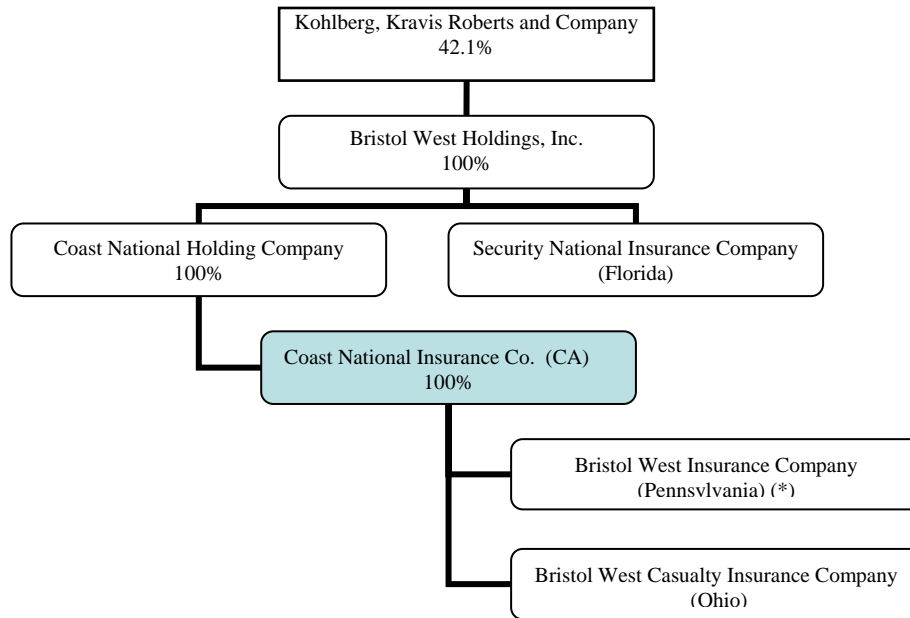
On August 11, 2006, BWH contributed to the Company \$15 million in cash as paid-in surplus.

COMPANY HISTORY

With respect to the period covered by this examination, gross paid-in and contributed surplus increased by \$149 million. During 2002, BWH contributed \$19 million in cash to the Company. The remaining \$130 million increase in gross paid-in and contributed surplus results from the combination of the following two transactions: (1) On June 30, 2003, the Company recorded a contribution receivable in the amount of \$20 million from its immediate parent, Coast National Holdings, which was settled in cash in August 2003. (2) During February 2004, BWH completed a public offering of its shares. In conjunction therewith, and in accordance with permission granted by the California Department of Insurance, the Company's 2003 Annual Statement depicted a \$110 million affiliate receivable. The proceeds were received by the Company during February 2004.

MANAGEMENT AND CONTROL

Ultimate control of the Company is maintained by Kohlberg, Kravis Roberts and Company. The following abbreviated organizational chart depicts the Company's relationship within the holding company system:



(*) Redomesticated to Ohio, effective September 21, 2006

Management of the Company is vested in a seven-member board of directors elected annually.

A listing of the members of the board and principal officers serving on December 31, 2005 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Jeffrey J. Dailey Davie, Florida	President and Chief Operating Officer Bristol West Holdings, Inc
Craig E. Eisenacher* Parkland, Florida	Senior Vice President and Chief Financial Officer Bristol West Holdings, Inc.
Gregory J. Hammond Boca Raton, Florida	Corporate Counsel Bristol West Holdings, Inc.
John L. Ondeck Southwest Ranches, Florida	Chief Information Officer Bristol West Holdings, Inc.
Simon J. Noonan Fort Lauderdale, Florida	Senior Vice President and Chief Actuary Bristol West Holdings, Inc.
Robert D. Sadler* Parkland, Florida	Senior Vice President - Marketing Bristol West Holdings, Inc.
James J. Sclafani Weston, Florida	Senior Vice President - Claims Bristol West Holdings, Inc.

Principal Officers

<u>Name</u>	<u>Title</u>
James J. Dailey	President
Craig E. Eisenacher*	Treasurer
George J. Hammond	Secretary
Richard B. Moncher	Actuary

*On November 27, 2006, the Company announced the resignation of Craig E. Eisenacher and the appointment of Robert D. Sadler as his replacement effective December 8, 2006.

Management Agreements

General Agency Agreements: The Company is a party to two affiliated general agency agreements concerning the production of its business. Since July 1998, Bristol West Insurance Services of California, Inc. and BWIS of Nevada, Inc. have been contracted to underwrite the Company's policies. As compensation for its services, the agencies receive 25% of net premiums written and 97.5% of all policy fees. The aforementioned agreements explicitly exclude the agencies from binding reinsurance or settling claims on behalf of the Company. Among the appointed duties depicted in the agency agreements is the collection of premiums. The agencies, however, are no longer responsible for the collection of premiums. Since 2001, the Bristol West Insurance Group has utilized the cash management services provided by a national bank to process and deposit directly all remittances. In view of the procedural change, the following recommendations are made: (1) In accordance with the filing and approval requirements of California Insurance Code (CIC) Section 1215.5 (b)(4), the Company must update its agency agreements to reflect existing duties and submit the agreements to the California Department of Insurance (CDI) for approval. (2) In order to assure that proper safeguards are in place to protect the Company's interests per se, management must submit an executed copy of the cash management agreement to the CDI for review and approval pursuant to CIC Section 1104.9.

Claims Services Agreement: Upon approval from the CDI in June 1998, the Company entered into a claims services agreement with its affiliate, Bayview Adjustment Bureau, Inc. (BABI). Under the terms of this agreement, BABI administers all aspects of the Company's claims operations, which include adjusting and settling claims. Compensation is based on actual expenses incurred.

Investment Services Agreement: Under the terms of an investment services agreement executed on May 1, 2000, Hyperion Capital Management, Inc. (HCM), an unaffiliated company, began managing the Company's fixed income portfolio. HCM's compensation is based on the average quarterly market value of the assets managed and the applicable basis points.

Tax Sharing Agreement: The Company and its affiliates are parties to a consolidated federal income tax agreement with the ultimate parent. Approval of the agreement was rendered by the CDI during

June 1998. Allocation of taxes is based upon separate return calculations with current credit for net losses. Inter-company tax balances were found to be settled in accordance with the terms of the agreement.

The following table depicts payments made by or (received) by the Company under the claims service, investment service and tax sharing agreements during the period under review:

Agreement	2002	2003	2004	2005
Claims Service	\$ 29,621,994	\$ 38,565,483	\$ 39,375,988	\$ 32,942,303
Investment Service	\$ 89,033	\$ 73,911	\$ 247,868	\$ 341,956
Tax Sharing	\$ (7,953,281)	\$ -0-	\$ 8,192,123	\$ 14,517,666

TERRITORY AND PLAN OF OPERATION

As of December 31, 2005, the Company was licensed to transact multiple lines of property and casualty insurance in the states of Arizona, California, Mississippi, Nevada, Oregon, Pennsylvania, and Tennessee.

The Company specializes in nonstandard private passenger automobile liability and physical damage coverages. With respect to the year 2005, 85% of the policies issued afforded statutory minimum limits of liability coverage. During that year, the Company wrote \$299.8 million of direct premiums. Of the direct premiums written, over 95% pertained to California risks. As previously noted, the Company is a party to two affiliate general agency agreements concerning the production of business. Approximately 4,300 independent agents and brokers write business for the two affiliated general agencies.

A claims processing branch office is maintained in Anaheim, California.

GROWTH OF COMPANY

The following table depicts the Company's substantial growth during the period under review:

Description	2002	2003	2004	2005
Assets	\$ 232,294,829	\$ 419,458,572	\$ 565,989,000	\$ 730,846,454
Liabilities	\$ 170,989,441	\$ 196,085,958	\$ 316,555,861	\$ 442,673,088
Surplus	\$ 61,305,388	\$ 223,372,614	\$ 249,433,139	\$ 288,173,366
Gross Premiums Written	\$ 350,998,609	\$ 495,144,867	\$ 639,124,098	\$ 524,105,744
Net Premiums Written	\$ 177,224,618	\$ 187,020,798	\$ 372,228,147	\$ 588,455,782

While the Company has experienced substantial growth in premium volume, such growth has been accompanied by a significant increase in surplus. As referenced in the Company History section of this report, surplus contributions during the period under review totaled \$149 million. With respect to the year 2005, the inverse relationship between gross and net premiums written stems from the commutation of the 2002 through 2004 quota share agreement covering accident years 2002 through 2004.

REINSURANCE

Assumed

Between January 1, 2000 and December 31, 2004, nine separate reinsurance agreements were established whereby three affiliates ceded the bulk of their business to the Company. The majority of such agreements provided for an adjustment of the cession/retention percentage on a retroactive basis.

The inclusion of the adjustable cession/assumption clause renders the agreements void of sufficient risk transfer to be accounted for as reinsurance under Statements of Statutory Accounting Principles (SSAP) No. 62. In order to account for its inter-company agreements as reinsurance in future annual statement filings, the Company must delete the adjustable cession/assumption provisions in the applicable agreements.

Ceded

Aggregate Excess of Loss Agreements: Effective January 1, 1998, the Company and Security National Insurance Company (affiliate) entered into an aggregate excess of loss reinsurance agreement with American Re-Insurance (Am Re) covering accident years 1998 through 2000 (first agreement). A review of treaty experience indicates that Am Re assumed premiums of \$11.6 million and was contractually liable for \$30 million of the Company's losses. In a letter dated May 21, 2002, Bristol West Holdings, Inc. (parent organization) affirmed that losses ceded under this contract would be limited to \$24,280,696. Bristol West Holdings, Inc. agreed to abate \$5,719,304 (\$30,000,000 less \$24,280,696) of Am Re's contractual liability. As referenced below, Am Re was afforded another extraordinary consideration relating to its participation in the first agreement.

A replacement agreement covering accident years 2001 through 2003 (second agreement) was executed on September 28, 2001 with Inter-Ocean Reinsurance Limited (Inter-Ocean) which is partially owned by Am Re. This agreement was brokered by an affiliate of Am Re. Effective November 15, 2001, a retrocession agreement between Inter-Ocean and Am Re was executed. Thus, Am Re served as the reinsurer of the first agreement and the retrocessionaire of the second agreement.

In accordance with the terms of this agreement, the reinsurer (Inter-Ocean) was entitled to a non-refundable margin (profit margin) equal to a stipulated percentage of the minimum and deposit premium for each covered underwriting year. Inter-Ocean has represented that out of the margin, the retrocessionaire (Am Re) was paid a yearly retrocession premium of approximately \$354,000, which represented no less than 80% of the margin for each underwriting year. Although losses were ceded, no reinsurance losses became payable as a result of the commutation of the agreement by the Company on March 18, 2004.

Approximately four months prior to the execution of the aforementioned second agreement, Inter-Ocean was granted a warrant to purchase 6,000 shares of Bristol West Acquisitions, Inc. common stock*. The warrant agreement provided that the warrant was neither subject to transfer nor

assignment. In contrast to the spirit of this restriction, however, the previously referenced letter dated May 21, 2002, which was issued to the presidents of both Am Re and Inter-Ocean, stipulated that any value realized from the options granted to Inter-Ocean would accrue to the benefit of Am Re. Management has represented that the exercise of the Bristol West Acquisitions, Inc. warrants resulted in an approximate \$4 million gain for Am Re (reinsurer of the first agreement and retrocessionaire of the second agreement). Correspondence between management and Am Re provides acknowledgement that the options were bestowed as a means to offset the experience deficit under the first agreement.

Section 8 of the Statements of Statutory Accounting Principles (SSAP) No. 62 provides, in part, that “The agreement shall constitute the entire contract between the parties and must provide no guarantee of profit, directly or indirectly....from the ceding entity to the reinsurer.” This section implicitly forbids the implementation of side arrangements which mitigates the transfer of risk.

The abatement of losses and the conveyance of stock options as a means to offset the adverse experience of the first agreement are deemed to constitute side arrangements. With consideration given to the connectivity between the two agreements, the implementation of such side arrangements rendered the second agreement in violation of Section 8 of SSAP No. 62. As such, and in accordance with precepts of Section 9 of SSAP No. 62, the second agreement was incorrectly accounted for as reinsurance.

*The Bristol West Holdings, Inc. Initial Public Offering took place on February 11, 2004. Connectivity between the first agreement (Am Re as reinsurer covering 1998 through 2000) and the second agreement (Am Re as retrocessionaire covering 2001 through 2003) was established via the following proviso contained in the aforementioned letter: The gain that Am Re could realize from the exercise of the options was limited to the net present value of any deficit in the combined experience account balances of the 1998 – 2000 and the 2001 – 2003 aggregate excess agreements.

Quota Share Agreements: Aside from the previously referenced aggregate excess agreements, the Company relied exclusively on quota share coverages during the period under review.

Effective January 1, 2002 (signed during September 2002), the Company entered into a three-year discretionary quota share agreement. For the years 2002, 2003 and 2004, the Company chose to cede 49.3%, 60.0% and 50% of its premiums, respectively. The reinsurers were National Union Insurance Company*(50%), Alea London Ltd**(40%) and Federal Insurance Company*** (10%). Effective January 1, 2005, the agreement was commuted on a cut-off basis.

On January 1, 2005, the Company entered into a two-year discretionary quota share agreement with National Union Insurance Company whereby the Company chose to cede 10% of its written premiums for the year 2005. As of January 1, 2006, the agreement was commuted on a cut-off basis.

With consideration given to (1) a review of the inherent contract provisions, (2) the representations offered by one of the non-affiliated reinsurers, and (3) the results of the risk transfer analysis conducted by the independent actuarial firm contracted by the California Department of Insurance, it has been concluded that both reinsurance transactions contain insufficient risk transfer to be accounted for as reinsurance under SSAP No. 62. Among the attributes of the agreements are the following:

- Loss Ratio Corridor - Between an 80% through 90% loss ratio, the reinsurers (2002 – 2004 agreement) were not liable for losses.
- Loss Cap - Under the terms of the 2002 through 2004 agreement, the reinsurers were not liable for losses above a 105% loss ratio; whereas the 2005 agreement capped the sole reinsurer's liability at a 107% loss ratio.

* Subsidiary of American International Group, Inc.

** Related party transaction - Kohlberg, Kravis Roberts & Company maintains a controlling interest in both Bristol West Holdings, Inc. which is the Company's parent organization and ALEA London Ltd.

*** Subsidiary of Chubb & Son Group, Inc.

- Special Termination Provision – The reinsurers of the 2002 - 2004 agreement were allowed to terminate the agreement at year-end 2003 if the estimated loss ratio from inception through September 30, 2003 was greater than 85%. The provisions of the 2005 agreement allowed the reinsurer to terminate the agreement at year-end 2005 if the estimated loss ratio from inception through September 30, 2005 was greater than 82%

➤ Profit Potential of Reinsurer(s) - Capped at the 3% margin

By written confirmation, Federal Insurance Company (Federal) provided the following response relating to its participation in the 2002–2004 quota share agreement: “At the end of 2003, Federal’s auditors recommended that Federal change its accounting for this contract to deposit accounting because certain contractual provisions, including a loss ratio corridor and a loss ratio cap, did not satisfy the criteria of paragraphs 12a and 13 of SSAP No.62. Accordingly, beginning in the first quarter of 2004, although the treaty still transferred risk, Federal did not account for the treaty as reinsurance under SSAP No. 62.”

For the purpose of evaluating compliance with the risk transfer requirements of SSAP No. 62, the California Department of Insurance retained the services of American Actuarial Consulting Group LLC (AACG). The evaluation of risk transfer encompassed both cash flow analyses and profit margin analyses under various scenarios, with consideration given to the impact of the special termination and commutation provisions. AACG has concurred with the reinsurer’s assessment that the 2002 – 2004 contract failed to pass the risk transfer requirements of SSAP No. 62. AACG further concluded that the 2005 contract was also lacking the requisite risk transfer attributes.

SSAP No. 62, Section 34 prescribes that an insurance company must utilize deposit accounting to account for reinsurance agreements that do not transfer sufficient risk. As represented by management, the aggregate accounting consequences of applying deposit accounting to the two discretionary quota share agreements for each of the years between 2002 and 2005 would be an overstatement of net income by approximately \$32 million. However, the impact on surplus as of year-end 2005 would be materially insignificant. In view of such, no examination change has been made for the disallowance of reinsurance credits. It is, however, recommended that the Company perform adequate risk transfer analysis on all future reinsurance agreements in accordance with SSAP No. 62.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2005

Statement of Financial Condition
as of December 31, 2005

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 378,806,435	\$	\$ 378,806,435	
Common stocks	43,367,048		43,367,048	
Cash and short-term investments	5,456,812		5,456,812	
Receivable for securities	4,910		4,910	
Investment income due and accrued	4,030,529		4,030,529	
Deferred premiums, agents balances and installments booked but deferred and not yet due	276,778,042		276,778,042	
Amounts recoverable from reinsurers	2,277,544		2,277,544	
Net deferred tax asset	16,049,883	183,600	15,866,283	
Aggregate write-ins for other than invested assets	<u>4,276,232</u>	<u>17,381</u>	<u>4,258,851</u>	
Total assets	<u>\$ 731,047,435</u>	<u>\$ 200,981</u>	<u>\$ 730,846,454</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 134,498,818	(1)
Reinsurance payable on paid losses and loss adjustment expenses			23,800,795	
Loss adjustment expenses			28,727,361	(1)
Commissions payable, contingent commissions and other similar charges			28,727,361	
Other expenses			1,221,391	
Taxes, licenses and fees			175,102	
Current federal and foreign income taxes			11,134,394	
Unearned premiums			195,392,186	
Ceded reinsurance premiums payable			13,172,464	
Payable to parent, subsidiaries and affiliates			<u>5,769,212</u>	
Total liabilities			442,673,088	
Common capital stock		\$ 1,200,000		
Gross paid-in and contributed surplus		213,078,921		
Unassigned funds (surplus)		<u>73,894,445</u>		
Surplus as regards policyholders			<u>288,173,366</u>	
Total liabilities, surplus and other funds			<u>\$ 730,846,454</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

Premiums earned		\$ 526,377,647
Deductions:		
Losses incurred	\$ 273,135,107	
Loss expenses incurred	62,775,450	
Other underwriting expenses incurred	<u>177,292,678</u>	
Total underwriting deductions		<u>513,203,235</u>
Net underwriting gain		13,174,412

Investment Income

Net investment income earned	\$ 13,074,596	
Net realized capital losses	<u>(33,183)</u>	
Net investment gain		13,041,413

Other Income

Finance and service charges not included in premiums	\$ 27,431,828	
Aggregate write-ins for miscellaneous losses	<u>(817,199)</u>	
Total other income		<u>26,614,629</u>
Net income before federal and foreign income taxes		52,830,454
Federal and foreign income taxes incurred		<u>22,238,975</u>
Net income		<u>\$ 30,591,479</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		\$ 249,433,139
Net income	\$ 30,591,479	
Change in net unrealized capital gains	2,707,145	
Change in net deferred income tax	5,520,263	
Change in nonadmitted assets	<u>(78,63,615)</u>	
Change in surplus as regards policyholders		<u>38,740,227</u>
Surplus as regards policyholders, December 31, 2005		<u>\$ 288,173,366</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2005

Surplus as regards policyholders, December 31, 2001,
per Examination \$ 21,031,979

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>
Net income	\$ 81,858,124	\$
Change in net unrealized capital gains	20,964,240	
Change in net deferred income tax	5,582,289	
Change in nonadmitted assets	9,912,222	
Change in surplus notes		1,500,000
Surplus adjustments: Paid-in	149,000,000	
Aggregate write-ins for gains in surplus	<u>1,324,512</u>	<u> </u>
Totals	<u>\$ 268,641,387</u>	<u>\$ 1,500,000</u>

Net increase in surplus as regards policyholders 267,141,387

Surplus as regards policyholders, December 31, 2005,
per Examination \$288,173,366

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

The Company was directed by the California Department of Insurance (CDI), under California Insurance Code (CIC) Section 733, to retain American Actuarial Consulting Group LLC (AACG) for the purpose of assessing the reasonableness of the Company's loss and loss adjustment expense reserves. Based on the analysis by AACG and the review of their work by a Casualty Actuary from the CDI, the Company's combined reserves for losses and loss adjustment expenses as of December 31, 2005 were determined to be reasonably stated and have been accepted for purposes of this examination report.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Management Agreements (Page 5): In accordance with the filing and approval requirements of California Insurance Code (CIC) Section 1215.5(b)(4), it is recommended that the Company update its agency agreements to reflect the current responsibilities of the agencies and submit the agreements to the California Department of Insurance (CDI) for approval.

Management and Control – Management Agreements (Page 5): In order to assure that proper safeguards are in place to protect the Company's interests per se, management must submit an executed copy of its cash management agreement to the CDI for review and approval pursuant to CIC Section 1104.9.

Reinsurance – Assumed (Page 7): In order to account for its intercompany agreements as reinsurance in future annual statement filings, the Company must delete the adjustable cession/assumption provisions in the applicable agreements.

Reinsurance – Ceded (Page 8): It is recommended that the Company perform adequate risk transfer analysis on all future reinsurance agreements and account for the agreements in accordance with SSAP No. 62.

Previous Report of Examination

Reinsurance - Assumed (Page 9): It was recommended that the assumed reinsurance agreements with Bristol West Insurance Company and Bristol West Casualty Insurance Company be amended to reflect the name changes from Reliant Insurance Company and Reliant Casualty Insurance Company. The reinsurance agreements were amended to reflect the name changes.

Reinsurance - Ceded (Page 11): It was recommended that the Company amend its reinsurance agreements to comply with CIC Section 922.2. The insolvency clauses were amended and the Company is now in compliance.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

_____/S/_____
David A. Fischman, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California